City of Austin MEMO

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November 19, 2002

To: Mayor and City Council

From: Stephen L. Morgan, City Auditor

Subject: Austin Energy's Debt Management Fund

The following is our memo report on Austin Energy's debt management fund (DMF). Our objectives were to determine whether:

- the original intent of the DMF had changed, and if so, why;
- the DMF was used as intended; and
- Austin Energy (AE) has controls in place such as a plan for the use and accrual of the fund.

We reviewed City resolutions, related financial policies, and the accrual and expenditure of Austin Energy's debt management fund from its inception in FY 96 through FY 02. In addition we interviewed staff from the City's Financial Services Department and AE and obtained information from other cities to identify utilities with similar funds.

This audit was conducted in accordance with generally accepted government auditing standards.

While the original intent of the DMF has not changed, AE management has obtained Council's approval on revisions to the resolution as conditions surrounding the utility have changed. The City Council passed a resolution creating the debt management fund in 1996. The resolution was passed out of a concern that the City would be forced into a deregulated marketplace and needed to maintain a competitive position. The resolution stated:

> The City will direct all excess electric utility cash to a debt management fund to be used to improve the competitive position of its electric utility by reducing debt and improving the debt to capital ratio…

The City Council approved changes to the resolution in 1999. With the passage of Senate Bill 7 (Texas Electric Industry Restructuring Legislation) in June of 1999, AE management recognized that the Utility would <u>not yet</u> be forced into competition; however, uncertainty about the future of deregulation still lingered. The revised resolution included additional uses, changing from a focus on debt reduction to also include other competitive initiatives. While retaining the same name, the DMF, AE proposed and the Council approved rate reductions and new technology as initiatives that may need to be undertaken to help sustain a competitive utility. The 1999 resolution stated that:

> The City will direct all excess electric utility cash to a debt management fund. The debt management fund will be used to improve the competitive position of its electric utility *including, but not limited to*,
> - funding capital needs in lieu of debt issuance,
> - reduction of outstanding debt,
> - improving the debt to capital ratio,
> - rate reductions, allocated in a fair and equitable manner across all classes of customers and
> - new technology. (italics added)

Citing the impact of the 2000-2001 California energy crisis and other competitive pressures on utilities, AE plans to propose an increase in available uses of the DMF. Austin Energy's new proposal will expand the purpose of the fund from the improvement of AE's competitive position through debt management and other initiatives to a contingency fund to help the utility remain competitive in times of crisis. Such a crisis might be a major increase in the purchase of power on the wholesale market or a spike in fuel prices. Even though AE may have other methods available to address some of the possible emergencies, AE states that a contingency fund is still justifiable. For example, AE has a fuel adjustment clause that allows it to adjust rates to reflect increases or decreases in the cost of fuel and purchased power. However, if reliance is placed on the fuel adjustment clause, AE customers could experience potentially volatile increases in fuel rates.

Austin Energy has spent approximately $50 million of the debt management fund in accordance with the purposes outlined in the resolution. As of the end of FY 02, the balance of the DMF was approximately $181 million. AE has used approximately $50 million in funds from the DMF in compliance with the resolution and financial policies as follows:

- $1 million in 1998 to defease debt,
- $36.8 million in 2001 to build the Sand Hill Energy Center in lieu of issuing debt,
- $2 million in 2002 to defease debt, and
- $10 million in 2002 transferred to the Repair and Replacement Fund to provide extensions, additions, and improvements to the electric system.

While the debt defeasance listed in two of the bullets above clearly reduces AE's debt, the construction of Sand Hill and the funding of the Repair and Replacement Fund reduce debt through debt avoidance. In this case, by using cash to pay for additional generation (Sand Hill) and improvements, additions, and extensions to the current electric system (Repair and Replacement Fund), AE has improved its debt to capital ratio by not incurring new debt.

The DMF has not been used to fund rate reductions or technology purchases.

While controls such as general policy direction, forecasting, and City Council approvals are in place, AE management does not have a document listing the criteria used for decisions when the DMF will be used for specific purposes. As mentioned earlier, general policy direction for the DMF was established through a Council resolution that describes the purpose of the fund and lists the areas in which the fund may be spent. In addition, similar to other City departments, AE compiles a five-year forecast projecting all revenues and expenditures including the DMF. Further, AE has expanded its five-year forecast to encompass ten years because the planning horizon for generation may not occur within the five-year window. However, AE management has not documented the criteria that would be used when deciding to use the DMF for any of the five stated uses. For example, AE might use the following criteria when planning to use the fund for debt defeasance:

- Market rates are lower than debt rates by X%
- Current debt is affecting bond ratings of the utility

While AE has plans to develop a debt defeasance schedule, such a document is not the same as a planning document that states criteria for decisions. AE management has expressed a need to maintain flexibility in order to take advantage of changing market conditions or apply the funds in the most advantageous manner. A written document stating criteria for decisions could allow that flexibility while also setting some boundaries on the use of the funds.

The ultimate control currently in place is City Council approval of expenditures from the fund, which ensures that the DMF is not spent on purposes other than those approved by the City Council. Currently, AE management brings spending decisions to the City Council for their approval.

The Council resolution did not provide a target for the accumulated balance of the fund. Without a specific target for the accrual of funds into the DMF, AE lacks policy direction on the relative priority of the DMF in relation to collected revenue. Since the DMF is funded through a portion of AE revenue, citizens might question how much money is needed to support the DMF in lieu of other financial policies that affect rate payers. Moreover, the absence of a targeted value for the DMF could create the perception that AE is accumulating too much money.

We identified one agency with a fund similar to the DMF; other utilities have funds with more limited purposes. As mentioned earlier, the main purpose of the DMF is to help AE be more competitive. The Municipal Electric Authority of Georgia (MEAG), has a Municipal Competitive Trust established to ensure a competitive position for participating utilities. MEAG is a public generation and transmission corporation that provides power to 49 communities in Georgia. Their Municipal Competitive Trust is described as a "strategic tool to mitigate future above market costs should electricity restructuring occur in Georgia."

In addition, some utilities, specifically those that are on the west coast and those that rely on hydropower have created rate stabilization funds. While maintaining stable rates is a part of being competitive, these funds are limited and cannot be used for other competitive initiatives such as the reduction of debt. For example, the Sacramento Municipal Utility District has a “rate stabilization” fund that was created to protect customers from energy market price fluctuations. The fund was depleted by higher wholesale energy costs associated with the California energy crisis. Since the fund has been depleted, Sacramento has instituted a rate stabilization surcharge to rebuild the fund. This surcharge will expire after two years or possibly sooner, once the fund is replenished. The City of Seattle is planning on establishing a similar fund that will be used to prevent borrowing money for operating costs in years of extreme drought, low load, or low wholesale prices. Conditions severe enough to warrant the use of the fund are expected to occur about once in 20 years.

RECOMMENDATIONS

1. As part of the current changes being considered for the DMF, the AE General Manager should propose to change the name of the debt management fund to more accurately reflect the uses of the fund.

2. To provide support for funding decisions, the AE General Manager should develop documented criteria that will be applied when deciding to use the DMF for the purposes listed in the resolution.

3. The AE General Manager should propose to Council a resolution that establishes a dollar limit for the fund. In establishing this limit, the General Manager should take into consideration the potential costs associated with activities approved in the current or revised resolution.

4. The AE General Manager should ensure that the City’s financial policies are amended to reflect the changes in the resolution.

TO: Stephen L. Morgan, City Auditor

FROM: Juan Garza, General Manager, Austin Energy

DATE: November 18, 2002

SUBJECT: **Austin Energy's Debt Management Fund**

The Office of the City Auditor has completed a memo report on Austin Energy's Debt Management Fund. We appreciate the opportunity to work with the City Auditor on this review of our policies and practices with respect to the Debt Management Fund. Objectives of the work were to determine whether:

- The original intent of the Debt Management Fund had changed, and if so, why;
- The Debt Management Fund was used as intended; and
- Austin Energy has controls in place such as a plan for use and accrual of the fund.

In December 1996, the City Council adopted a Resolution setting long-range financial targets for Austin Energy in preparation for electric deregulation. The original intent of the Debt Management Fund, established by this 1996 Resolution, has not changed. However, in 1999, policy revisions were adopted by the City Council in response to increased uncertainty about the future electric market following passage of Senate Bill 7 (Texas Electric Industry Restructuring Legislation). These policy revisions included additional uses for the Debt Management Fund, changing from a specific focus on debt reduction to include a broader focus on initiatives that would strategically improve the competitive position of the electric utility.

Excerpt from Original 1996 Policy Resolution.
The City will direct all excess electric utility cash to a debt management fund to be used to improve the competitive position of its electric utility by reducing debt and improving the debt to capital ratio…

Excerpt from September 14, 1999 Revised Policy Resolution.
The City will direct all excess electric utility cash to a debt management fund. The debt management fund will be used to improve the competitive position of its electric utility including, but not limited to,

- *funding capital needs in lieu of debt issuance,*
- *reduction of outstanding debt,*
- *improving the debt to capital ratio,*
- *rate reductions, allocated in a fair and equitable manner across all classes of customers and*
- *new technology.*

Use of Debt Management Fund	12-1996 Policy	09-1999 Policy
Improve competitive position	Yes	Yes
Funding capital needs in lieu of debt issuance		Yes
Reduction of outstanding debt,	Yes	Yes
Improving the debt to capital ratio	Yes	Yes
Rate reductions, allocated in a fair and equitable manner across all classes of customers		Yes
New technology		Yes

Although not reflected in the policy, the Debt Management Fund is also the electric utility's only contingency fund for unexpected emergencies such as revenue shortfalls, emergency power purchases, rate stabilization and other emergencies. Austin Energy is considering proposed revisions to the policy for these purposes.

Austin Energy believes expenditures to date from the Debt Management Fund are consistent with Council policy direction and its intended uses. All expenditures made from the Debt Management Fund have been approved by the City Council (annual budget and/or budget amendments). Expenditures to date include:

Debt Management Fund Expenditures Inception to Date	Date Approved by Council	Amount
Debt Defeasance	1998	$ 1,000,000
Sand Hill Energy Center Steam Turbine Contract	October 1, 2000	$ 36,800,000
Debt Defeasance, Separate Lien Revenue Refunding Bonds, Series 2002	March 28, 2002	$ 2,200,000
Transfer to Repair and Replacement Fund to provide for extensions, additions, and improvements to the electric system	September 12, 2001	$ 10,000,000
Total expended through September 30, 2002		**$ 50,000,000**

At September 30, 2002, the balance in the Debt Management Fund was approximately $181 million. With an additional $10 million transfer to the Repair and Replacement Fund budgeted for 2003, the projected balance at September 30, 2003 will be $171 million.

Austin Energy has controls in place including Council policy direction in the Resolution, Council approval of annual budget as well as any expenditure made from the Debt Management Fund and long range financial plans reflecting use, accrual and accumulated balance of the Debt Management Fund. Specific criteria for decisions about use of the Debt Management Fund have been less formal and are not in writing, although long-range recommendations for use have been discussed with the City Council in Executive Session.

Auditor's Recommendations and Management's Response

Austin Energy concurs with three of your stated recommendations and partially concurs with a fourth. Following are responses to your recommendations:

NOTE: Auditor's Recommendation (Bold Italics) followed by Management's Response

1. ***As part of the current changes being considered for the DMF, the AE General Manager should propose to change the name of the debt management fund to more accurately reflect the uses of the fund.***

   Concur. The original intent of the Debt Management Fund has not changed. However, 1999 policy revisions included additional uses, changing from a specific focus on debt reduction to include a broader focus on initiatives that would strategically improve the competitive position of the electric utility. This broader focus is not reflected in the name Debt Management Fund and a more accurate name is needed.

   Austin Energy will bring a recommendation to Council for renaming the Debt Management Fund to reflect the intent to use the fund as a strategic tool to improve the electric utility's competitive position. Austin Energy proposes "*Competitive Strategy Fund*" as the fund's new name.

2. ***To provide support for funding decisions, the AE General Manager should develop documented criteria that will be applied when deciding to use the DMF for the purposes listed in the resolution.***

   Concur. Austin Energy will develop and document in writing criteria to guide strategic planning for decisions to expend Debt Management fund monies for those contingencies that have a reasonable probability of occurring. However, the strength of our strategic policy is the flexibility it provides to handle competitive or other contingencies that the City and Austin Energy cannot foresee. This puts Austin on a firm foundation for response, rather than a reactionary position.

3. ***The AE General Manager should propose to Council a resolution that establishes a dollar limit for the fund. In establishing this limit, the General Manager should take into consideration the potential costs associated with activities approved in the current or revised resolution.***

   Partially Concur. Austin Energy will develop and recommend to the City Council a policy for use in establishing the accumulated balance in the Debt Management Fund. This policy may be a flat dollar target, percent of revenues, number of days operating cash on hand or other formula or measure. In developing this policy, we will consider the cost of allowable uses and the strategic goal of the fund. As electric market conditions warrant, the recommended balance may need to be reset from time to time as approved by the City Council.

4. ***The AE General Manager should ensure that the City's financial policies are amended to reflect the changes in the resolution.***

   Concur. Revisions to the City's financial policies will be brought to the City Council for approval to reflect any amendments or changes to the September 14, 1999 Resolution on Electric Competition that affect such financial policies. The City's financial policies are reviewed annually during the budget process and amendments are incorporated into Council's budget adoption process, following a review by the Audit and Finance Committee.

Other Public Power Utilities with Similar Funds

The City Auditor's report pointed out that there are other public power utilities with similar funds including Municipal Electric Utility of Georgia (MEAG), Sacramento Municipal Utility District (SMUD) and Seattle City Light. In addition, the City of Tallahassee, Florida electric utility also has a similar fund. MEAG's Municipal Competitive Trust (MCT) is the most similar to Austin Energy's Debt Management Fund and is specifically directed to improving the competitive position of MEAG. Rate Stabilization Funds of varying amounts and purposes have been set up by SMUD and Tallahassee. Seattle's City Council recently adopted a new financial policy establishing a cash reserve for its electric utility.

In each case, these funds were established to meet a specific need of the respective utility to enable them to better respond to changing market conditions and/or deregulation. **In a rapidly changing industry, these cash funds represent a significant financial resource and strategic tool that allow these utilities improved flexibility to respond to emerging competitive pressures.**

Municipal Electric Utility of Georgia (MEAG)

Municipal Competitive Trust (MCT) established in 1999

- MEAG is third largest power supplier in Georgia with energy sales over $600 million in 2000. Public generation and transmission joint action agency providing power to 48 Georgia communities that in turn bring energy to almost 750,000 citizens
- Purpose of MEAG's Municipal Competitive Trust (MCT)
  - Strategic tool to mitigate future above-market costs should electric restructuring occur in Georgia
  - Designed to help maintain competitive wholesale rates when competition begins
  - Ensure competitive position guarding against unforeseen price increases
- Uses of MEAG's Municipal Competitive Trust (MCT)
  - Except for flexible account and for certain limited uses permitted prior to the commencement of retail competition in Georgia, MCT will be applied only as a <u>reduction to Participants costs under the power sales contracts</u>, when necessary to maintain retail competitiveness
- Balance of MEAG's Municipal Competitive Trust (MCT)
  - Initially funded with approximately $441 million and has grown to $559 million at December 31, 2001.
  - Projected to grow to over $1 billion by 2009
  - Funded with rate stabilization, debt service reserve, Participants' discretionary funds

Sacramento Municipal Utility District (SMUD)

Rate Stabilization Fund

- SMUD generates, transmits and distributes electric power to a 900 square mile service area serving over 525,000 customers with annual revenue of over $1.5 billion in 2001
- Purpose
  - Savings account used to keep rates steady even in dry years
  - Build a surplus to cover unexpected energy costs
  - Hedge against unpredictable wholesale energy prices and future dry hydro years
  - Defer the need for future rate increases
- Uses
  - Rate Stabilization Fund was depleted in just 10 months of historically high wholesale energy prices associated with the California energy crisis in 2000 and 2001
  - Used $26.2 million in calendar 2000 and $42.9 million in 2001
- Balance
  - Rate Stabilization Fund grew to almost $100 million
  - In response to the California energy crisis, in May 2001, SMUD implemented its first rate increase in eleven years
    - 13% rate increase for residential customers
    - 3% temporary surcharge for twelve months to cover the dry hydro year
    - Added a Rate Stabilization temporary surcharge of approximately 3 percent, or about a quarter of a cent per kilowatt-hour that will rebuild the Rate Stabilization Fund over a three year period

City of Tallahassee, Florida Electric Utility

Long Term Rate Stabilization Reserve

- City of Tallahassee electric utility generates, transmits and distributes electric power to a 221 square mile service area serving over 98,000 customers with annual revenue of over $243 million in 2001
- Purpose
  - Used to offset rate increases or for rate stabilization
  - Hedging against electric competition or deregulation has been a major City focus due to reliance on utility General Fund Transfers that currently fund 32% of the City's general fund
- Balance
  - Accumulate at a level of $2.5 million in FY95 and an additional $2.0 million annually thereafter, or as modified by the City Commission

Seattle City Light

- Department of the City of Seattle with a 131.3 square mile service area serving more than 345,000 customers with annual revenues of over $503.4 million in calendar 2001. Owns or contracts for approximately 80% of its own hydroelectric generating needs and obtains the remainder primarily through the Bonneville Power Administration.
- Uses
  - Incurred extraordinary purchased power costs in 2000 and 2001 with tremendous financial impact while purchasing only 10% of its power needs during Western energy crisis
  - $590 million budget impact
  - Raised rates four times in 2001 or about 47% to cover some of high power costs but substantial amount of borrowing was still necessary (bonds and loan from General Fund)
  - Issued $182.2 million in March 2001 in two-year Revenue Anticipation Notes as special limited obligation of the City payable from and secured by revenues of Seattle City Light. Funds were used to finance 2001 electric operating expenses.
  - Borrowed $110 million in December 2001 from City of Seattle's cash pool to meet short term cash needs payable on or before March 31, 2003
- City Council adopted new policy for establishment of a cash reserve

Conclusion

Austin Energy's Debt Management Fund is a key strategic tool that provides the City and utility the opportunity to better respond to changing electric market conditions in a rapidly changing industry. This fund also ensures the City and utility have the much-needed flexibility to respond to emerging competitive pressures.

I would like to express my appreciation to the City Auditor and to the team that worked on this project. Please contact me at 322-6002 if you need further information after reviewing this response.

Juan Garza

Juan Garza
General Manager
Austin Energy

Cc: Toby Hammett Futrell, City Manager
John Stephens, CPA, Acting Assistant City Manager
Vickie Schubert, CPA, Acting Director Finance and Administrative Services
Barbara Nickle, City Controller, Finance and Administrative Services

ACTION PLAN
AUSTIN ENERGY'S DEBT MANAGEMENT FUND AUDIT

Rec. #	Recommendation Text	Concurrence	Proposed Strategies for Implementation	Status of Strategies	Responsible Person	Proposed Implementation Date
01	As part of the current changes being considered for the DMF, the AE General Manager should propose to change the name of the debt management fund to more accurately reflect the uses of the fund.	Concur.	The original intent of the Debt Management Fund has not changed. However, 1999 policy revisions included additional uses, changing from a specific focus on debt reduction to include a broader focus on initiatives that would strategically improve the competitive position of the electric utility. This broader focus is not reflected in the name Debt Management Fund and a more accurate name is needed. Austin Energy will bring a recommendation to Council for renaming the Debt Management Fund to reflect the intent to use the fund as a strategic tool to improve the electric utility's competitive position. Austin Energy proposes "*Competitive Strategy Fund*" as the fund's new name.	Planned.	General Manager	Spring 2003. Austin Energy proposes "*Competitive Strategy Fund*" as the fund's new name.

Rec. #	Recommendation Text	Concurrence	Proposed Strategies for Implementation	Status of Strategies	Responsible Person	Proposed Implementation Date
02	To provide support for funding decisions, the AE General Manager should develop documented criteria that will be applied when deciding to use the DMF for the purposes listed in the resolution	Concur.	Austin Energy will develop and document in writing criteria to guide strategic planning for decisions to expend Debt Management fund monies for those contingencies that have a reasonable probability of occurring. However, the strength of our strategic policy is the flexibility it provides to handle competitive or other contingencies that the City and Austin Energy cannot foresee. This puts Austin on a firm foundation for response, rather than a reactionary position.	Planned.	General Manager	Spring 2003
03	The AE General Manager should propose to Council a resolution that establishes a dollar limit for the fund. In establishing this limit, the General Manager should take into consideration the potential costs associated with activities approved in the current or revised resolution.	Partially Concur.	Austin Energy will develop and recommend to the City Council a policy for use in establishing the accumulated balance in the Debt Management Fund. This policy may be a flat dollar target, percent of revenues, number of days operating cash on hand or other formula or measure. In developing this policy, we will consider the cost of allowable uses and the strategic goal of the fund. As electric market conditions warrant, the recommended balance may need to be reset from time to time as approved by the City Council.	Planned.	General Manager	Spring 2003

Rec. #	Recommendation Text	Concurrence	Proposed Strategies for Implementation	Status of Strategies	Responsible Person	Proposed Implementation Date
04	The AE General Manager should ensure that the City's financial policies are amended to reflect the changes in the resolution.	Concur.	Revisions to the City's financial policies will be brought to the City Council for approval to reflect any amendments or changes to the September 14, 1999 Resolution on Electric Competition that affect such financial policies. The City's financial policies are reviewed annually during the budget process and amendments are incorporated into Council's budget adoption process, following a review by the Audit and Finance Committee.	Planned.	General Manager	**Council Adoption of the FY 2004 Budget.** The City's financial policies are reviewed annually during the budget process and amendments are incorporated into Council's budget adoption process, following a review by the Audit and Finance Committee.

Concurrence: concur, partially concur, or disagree.
Status of strategies: planned, underway, or implemented.